F&T Farley & Thompson
STOCKBROKERS AND INVESTMENT MANAGERS

Risk & diversification

Risk and diversification are important factors to consider when making any new investment. Here are some ways to understand them.

What is Risk?

Risk is defined as the chance that an investment's actual return will be different from what you expected. It is therefore important to understand the relationship and trade-off between risk and return, and the main factors that influence different investments.

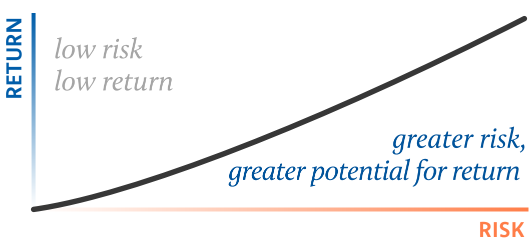
Virtually all investment involves some degree of risk, so it is crucial that you acknowledge and accept this and find a level of risk that you are comfortable with.

How much risk are you willing to take?

Your ability to accept risk is known as your 'risk capacity' or 'capacity for loss'. Generally, an investor who has a high proportion of capital and income wealth relative to their liabilities, and who has a long investment time horizon, will have a higher capacity for loss than someone with more limited wealth or a shorter time horizon.

Your 'attitude to risk' (or 'risk appetite') refers to the level of risk you are willing to take when selecting investments to help you achieve your objectives. It also refers to your ability to tolerate market swings (volatility) as well as the chances of suffering a complete loss. The prospect of losing money will be very distressing for some; others, however, will be more relaxed about it.

Your age and financial circumstances are just two of the factors that may influence your ability to take risk and your attitude to risk in general.



A simple formula for understanding risk and return

The principal forms of investment risk that investors face are:

Systematic risk

The risk that the overall stock market will rise or fall as economic and other market factors change. This type of risk could affect returns over a period of time, or have a more immediate impact if an investor buys at the top of the market or sells at the bottom: i.e. bad timing. Systematic risk causes similar fluctuations in all investment returns.

Unsystematic risk

Whereby different factors cause movements in the returns of different investments. Examples include industry risk caused by factors specific to a business sector (rather than general to the market), and stock-specific risk that affects one particular company. In other words, unsystematic risk (or non-systematic risk) is unique to a specific company or industry.

What is diversification?

A simple way to describe diversification of risk is: "don't put all your eggs in one basket". We can use diversification to moderate risk within your portfolio, since individual investment variables may offset one another. This can be achieved in the following ways:

- Diversification of asset class (e.g. cash, fixed interest, equities, property, commodities)
- Diversification within the asset class (e.g. by sector, region or market)
- Diversification by product type (e.g. shares, investment trusts, unit trusts, open-ended investment companies (OEICs) or exchange-traded funds (ETFs))
- Diversification by fund manager, product provider or investment strategy.

FARLEY & THOMPSON LLP

For **definitions**, please see our **Glossary**.

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Do you have a low, medium or high attitude to risk?

When it comes to accepting risk, every investor is different. The following descriptions may help you to define your own attitude to risk. **If you consider yourself to be...**

RISK AVERSE

VERY LOW RISK

You are unlikely to want to take any risk with your capital

You will generally prefer cash-based products, such as building society accounts and national savings

You regard the security of your money as paramount — more so than the buying power of the money (although this power would be gradually eroded by inflation)

LOW—MEDIUM RISK

You are likely to be cautious and concerned about security of capital, but understand the need to protect it from the effects of inflation

You are prepared to accept a small amount of risk in order to achieve modest returns

You are unlikely to ever invest in direct shares, but you are comfortable with collective investments, some of which may be invested internationally

You understand the basics of risk and reward and know that your investments will fluctuate in value. You accept it may be necessary to sacrifice some of the money you invest for the prospect of better long-term growth

RISK TOLERANT

MEDIUM RISK

You are prepared to take some risk in order to achieve your financial goals, seeking a balance between safety and investment growth potential

You are likely to want to invest in a way that does not expose all your capital to riskier investments, since you do not like extreme volatility

You are likely to want to have a spread of investments, some of which may be outside the UK

You understand risk and reward and know that your investments will fluctuate in value. You accept it may be necessary to sacrifice some of the money you invest for the prospect of better long-term growth

UPPER MEDIUM RISK

You are likely to be familiar with investing and already hold a proportion of your wealth in non-cash assets

You are prepared to accept the higher levels of risk associated with direct equity investments as you seek a balance between conservative and higher returns

You are likely to want to have a spread of investments, some of which may be outside the UK

You are familiar with most asset classes and are aware of the general risks associated with each of them

You fully understand risk and reward and know your investments will fluctuate in value. You accept there's a real risk of loss of capital, but know this is balanced with the prospect of greater growth

RISK TAKER

MEDIUM–HIGH RISK

You are likely to be an experienced and knowledgeable investor who is comfortable with taking risk

You already receive a secure income from other sources

You are happy to invest in all areas and asset types, and are looking for higher potential returns

You are likely to be attracted to illiquid investments, such as the Alternative Investment Market (AIM)

You fully understand risk and reward and know your investments could be subject to extreme volatility. You accept there's a real risk of loss of capital, but know this is balanced with the prospect of greater growth

HIGH RISK

You already actively manage your own investment portfolio and you are comfortable with significant risk

You are seeking to invest in the most speculative and volatile asset types, such as stock and index futures and options, derivatives, leveraged commodities, venture capital and enterprise trusts, as well as emerging market and frontier single-country funds, or a very narrow asset class

You fully understand risk and reward, and acknowledge your investments could be subject to extreme volatility.

You accept that the most speculative investment transactions come with a real risk of complete loss of capital

If you are planning to invest in the stock market you should:

1. Make sure you are prepared to accept some level of risk
2. Ensure that you only invest what you can afford to lose
3. Be happy to invest for a minimum of 5 years

Over the years, as your circumstances change, it is likely that your investment objectives may also change, and this in turn is likely to affect your attitude to risk. Please always let us know if your circumstances alter, because it may affect the way we manage or advise you on your investments.

Please remember that whatever your investment plans, your capital is always at risk.

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